

# **State of Arizona**

**Janet Napolitano, Governor**

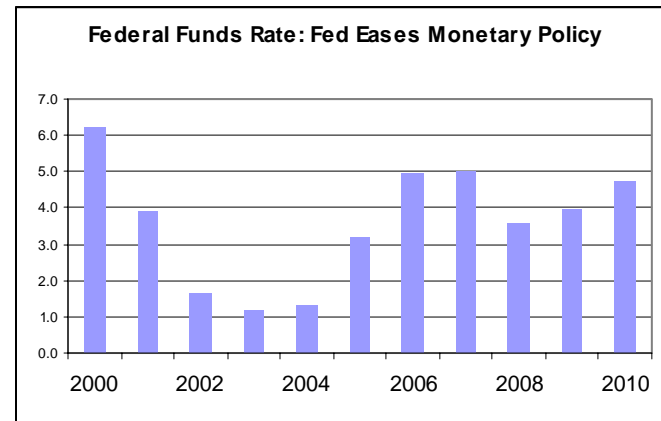
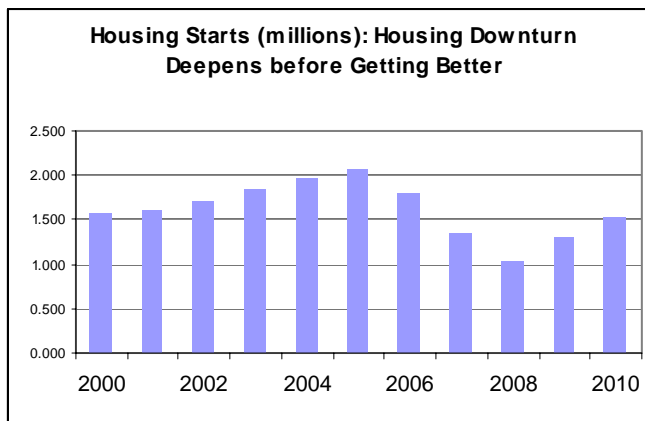
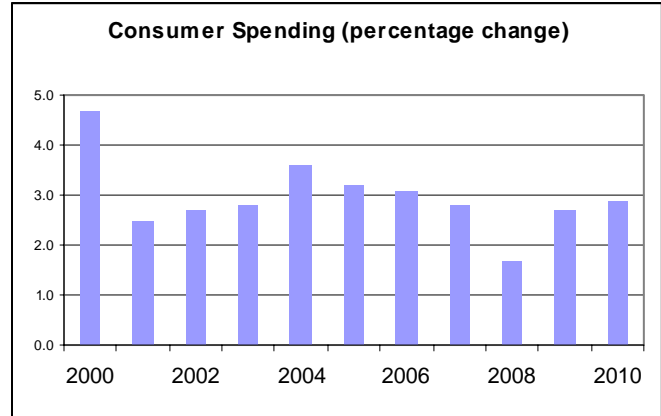
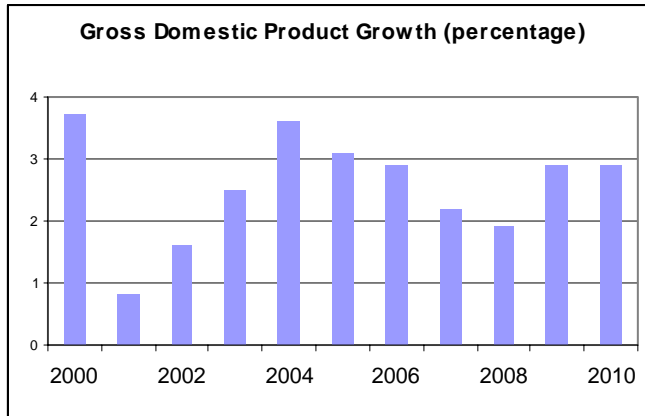
## **Budget Management Plan**

**Fiscal Year 2008**

**January 3, 2008**

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# National Economic Indicators – Calendar Years 2006 Through 2008



Source: Global Insight

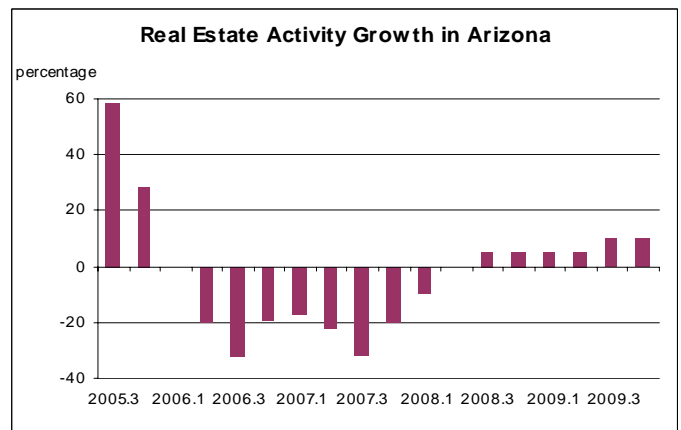
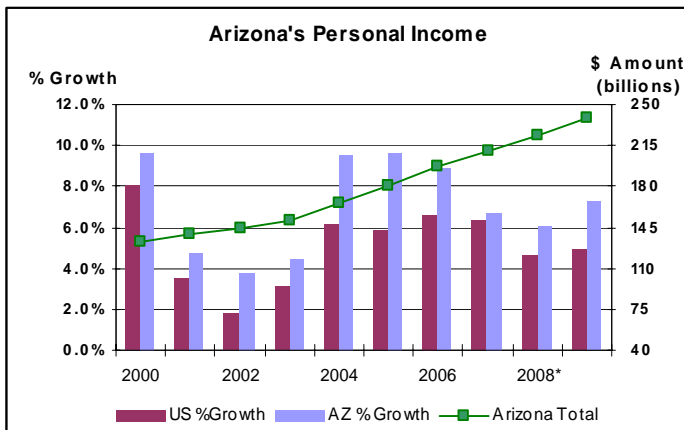
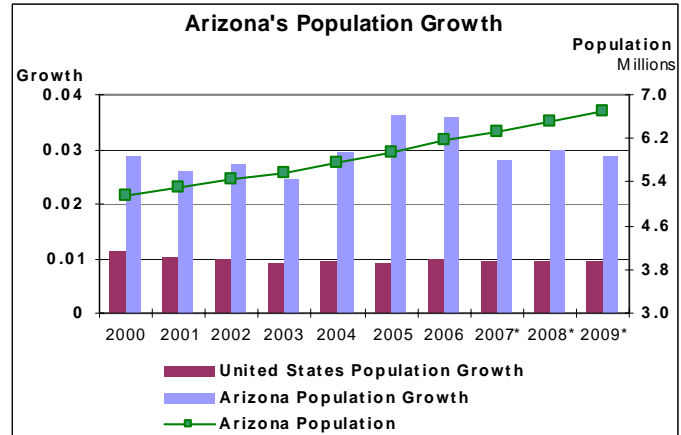
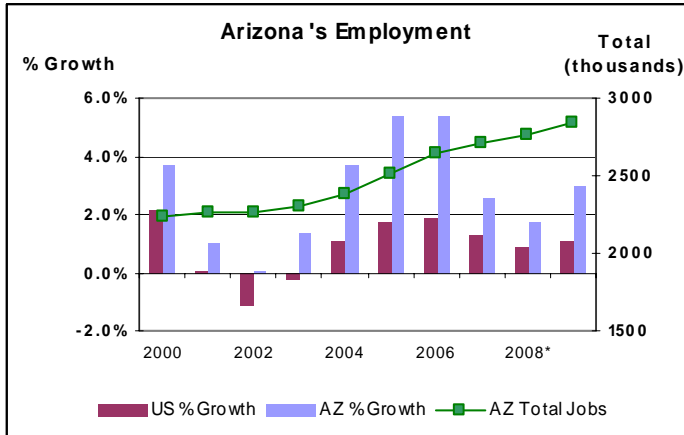
## I. National Outlook

- Growth in real Gross Domestic Product (GDP) during 2006 was solid, at 2.9%; GDP growth is expected to slow and is projected at 2.2% in 2007 and 1.9% in 2008, before recovering to 2.9% in 2009.
- Employment growth in 2007 was moderate at 1.3%, and is slowing with estimated growth of 0.8% in 2008.
- Consumer spending is slowing as consumers face declining home prices, with an estimated 2.8% growth rate in '07, slipping to 1.7% in '08.
- The Fed fund rate is likely to ease to help boost economy growth.
- Business spending has been consistent and robust in the past 5 years, is likely to slow through the first 3 quarters of '08.
- The dollar continued to fall in 2007, and further decline is anticipated in 2008 at a moderate level. The decline of the dollar makes US exports cheaper, therefore promoting greater US exports, helping to boost GDP growth.
- Trade deficit is likely to narrow the gap to \$755 billion in 2007, and is expected to improve further in 2008.

## II. National Risks

- Deeper housing prices decline, tighter credit availability, plus high energy prices could lead to further contraction in consumer spending.
- Possible spillovers from the hardship of the Midwest's structural manufacturing slump could cause further erosion in the economy.
- Energy prices: If energy prices remain at high levels, inflation rate could rise, limiting the Fed's ability to provide credit relief for the economy.
- Uncertainty caused by the major election in 2008 could contribute to a temporary slowdown in consumer activity as consumers put off major purchases.

# Arizona Economic Indicators – Calendar Years 2006 Through 2008



Source: US Census Bureau, BEA, Arizona DES

\*2008 and 2009 are projections from Census Bureau, Global Insight, Arizona DES, Arizona Blue Chip, and ASU

## III. Arizona Outlook

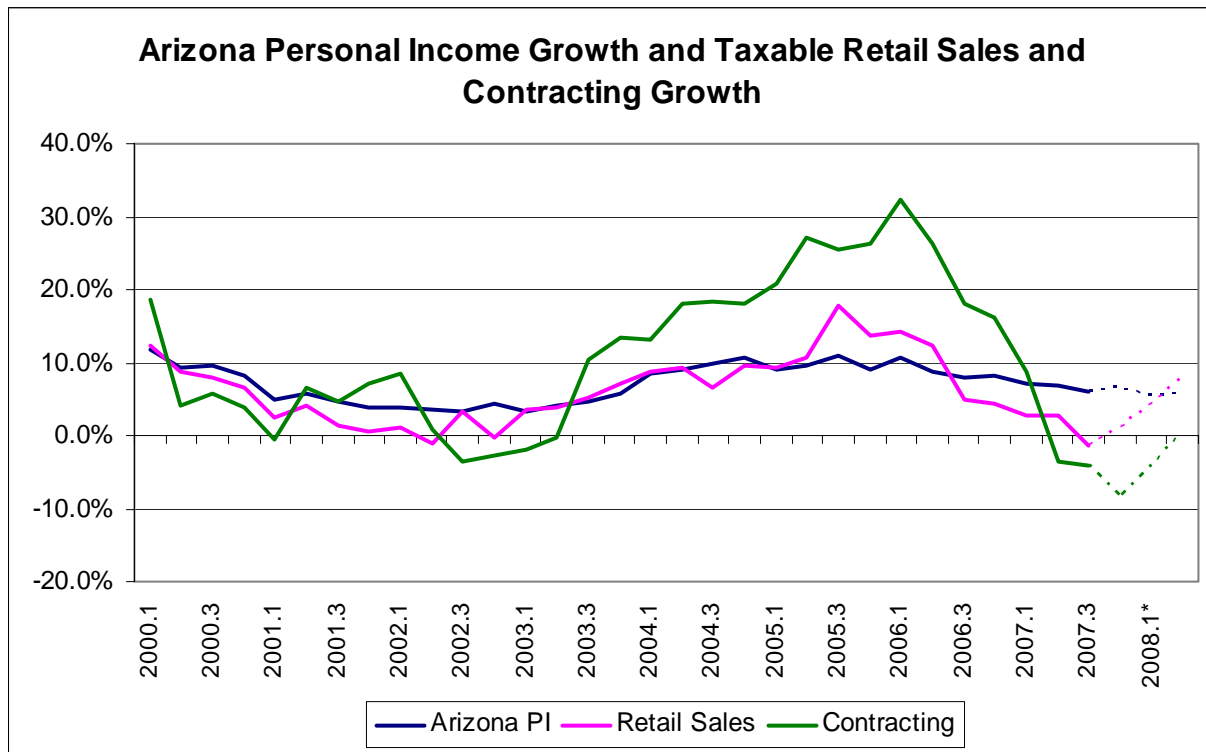
- Population growth in 2007 was 2.9% annually, ranked 2<sup>nd</sup> in the nation; in-migration/in-flows remain strong.
- Employment growth was strong in 2006 with 5.4% growth, but slowed sharply in the 2<sup>nd</sup> half of 2007. Arizona economy is expected to continue to grow at a lower estimated growth rate of 2.5% in 2007 and 1.7% in 2008, and is expected to maintain a position among the leaders in the nation.
  - From January 2003 to November 2007, Arizona added 500,500 jobs.
  - Arizona's unemployment rate, currently at 4.1% is lower than the national average of 4.7%
  - Big corporations, such as Intel, are expanding in Arizona, creating new high-wage jobs.
- Personal income (PI) growth for 2006 of 8.9% ranked 3<sup>rd</sup> in the nation (after Louisiana and Wyoming); PI growth has slowed to 6.7% in the first 3 quarters of '07, and is expected to grow at 6.0% in '08.
- Consumers continue to spend at a slower rate; retail sales are estimated to grow 4.4% in 2007, and 4.2% in 2008, according to Arizona Blue Chip's consensus forecast.

## IV. Arizona Risks

- Any prolonged national downturn will adversely affect the state as it has in the past. Arizona's export, construction and hospitality industries would suffer.
- Arizona is more exposed than most states to the real estate cycle. The state enjoyed considerable growth and prosperity in the up trend of the cycle and in 2007 will experience a drag due to the slowing of real estate activity.
- Lack of a comprehensive federal immigration policy is having an adverse effect on Arizona's economy.

## Impact of the Economy on Revenue Collections

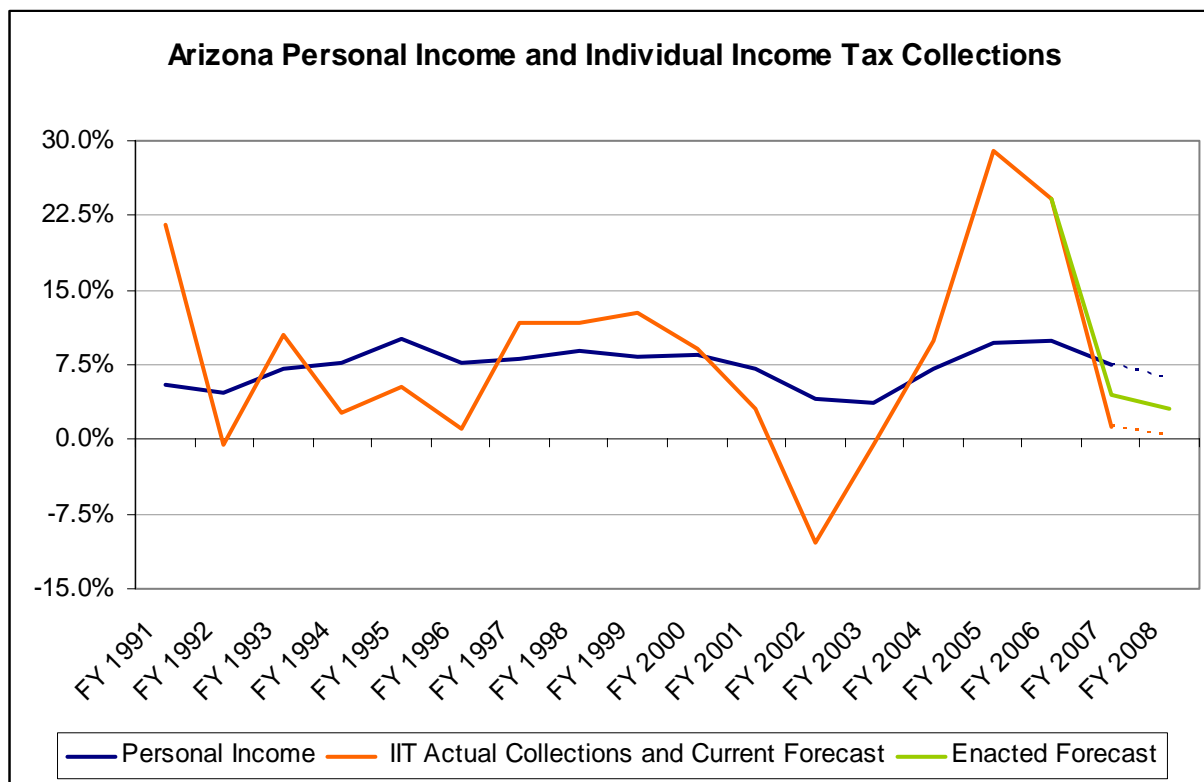
**Economic Activity:** Arizona will continue to enjoy rates of overall economic growth in aggregate wages and salaries that outstrip growth in the nation by several percentage points. Growth is fueled by a strong export sector in the States leading industries; hospitality, electronic manufacturing, aerospace and defense industries. Nevertheless, as the housing market continued to slow, revenue collections, after a period of displaying extraordinary robust growth, is expected to grow at a slower rate before returning to a normal, healthy growth rate that reflects the economy's growth.



(\*Note: dotted lines represent forecast)

**Taxable Retail Sales Collections:** The pace of retail sales activity has slowed considerably over the last six months in Arizona. Tax collections in Arizona are growing at a rate far slower than the overall Arizona economy. The reasons for the slower growth are primarily related to the abnormally high consumer spending due to easy credit availability from refinancing homes and rebates from car manufacturers during the strong economic period of 2005 and 2006. Consumers have ratcheted back expenditures on automobiles and housing related consumer durables. The expectation is that retail sales collections will display more normal growth patterns, albeit from a lower base, as we move into the second half of FY 2008 and continue to improve into FY 2009, reaching a pace that matches growth in the overall economy 12-18 months from now.

**Other taxable TPT categories:** Overall TPT collections in the State are also strongly influenced by “use” tax collections, contracting collections, and utilities collections. The use category is in turn buffeted by decisions of businesses to expand plants or stores, purchase new equipment, and by assessments on fuel acquired by utility companies. Contracting collections will be very slow for the foreseeable future with strong commercial sector collections limiting the downside from declining residential collections. Utilities collections will remain strong as companies continue to pass recent rate hikes through to consumers.



(\*Note: dotted lines represent forecast)

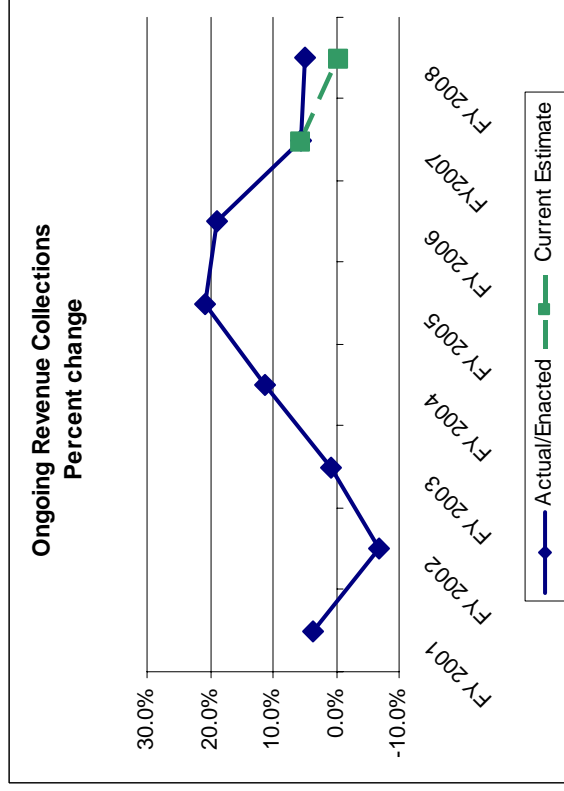
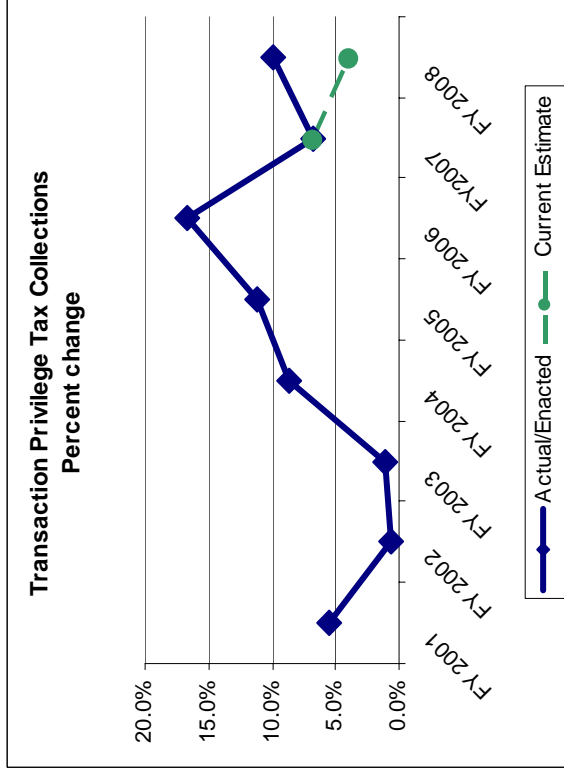
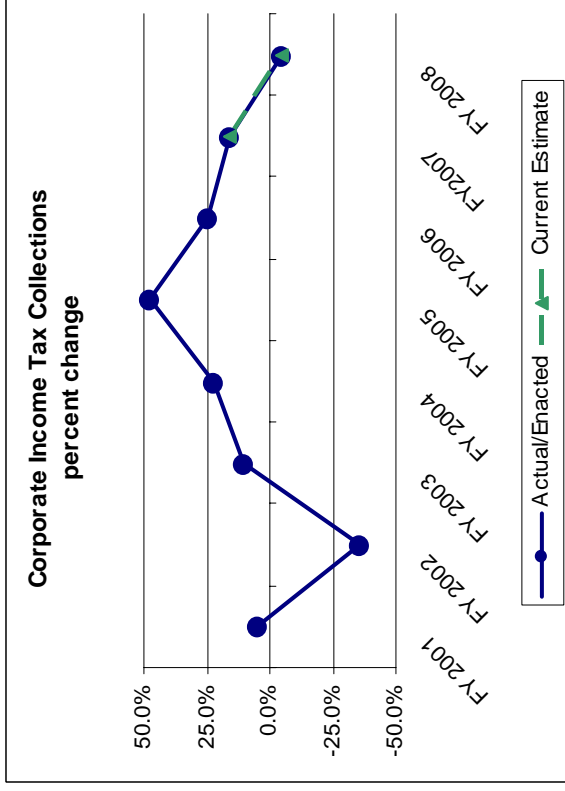
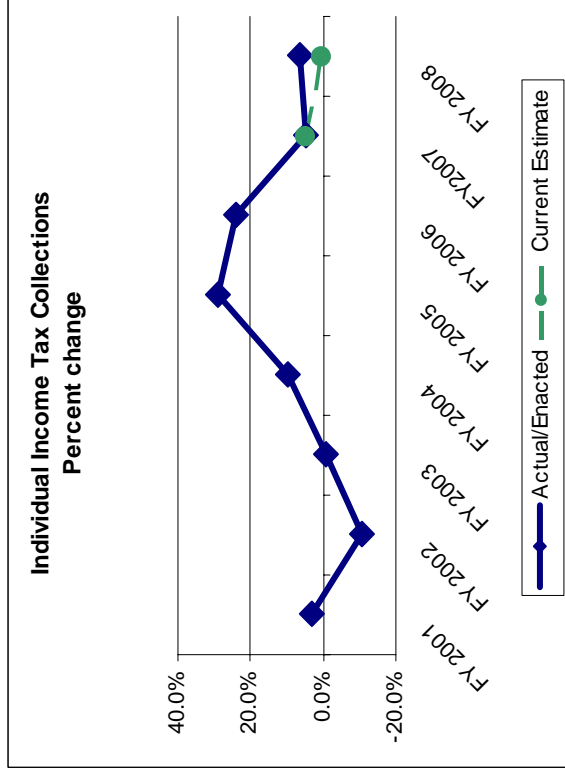
**Individual Income Tax Collections:** Over the last five years, Arizona individual income tax collections have displayed strong growth, fueled by solid wage and salary expansion and huge increases in capital gains and sole proprietor activity. Historically Arizona capital gains collections have been bolstered by strong equity markets and strong real estate markets. Collections will slow over the next several years as investor driven real estate activity wanes offset by strong equity market activity. Withholding collections have continued to display modest growth – at about the overall pace of the economy. Slower overall collections in FY 2007 and FY 2008 reflect sequential 5% income tax rate reductions.

**Corporate Profits:** The underlying health of the Corporate sector in Arizona and growth in the profitability of companies with a strong presence in the State will likely continue to outstrip average profitability nationally. Collections growth will be modest as recent statutory changes (Corporate consolidation and Sales factor formulas) work through the system.

**FY08**  
**Revenue Forecast**  
**General Fund**  
**(Dollars in Millions)**

	Actual FY06	Enacted Budget FY 07	% change	Actual FY07	% change from FY06	Enacted Budget FY 2008	% change from Actual FY07	Current Estimate FY 08	% change from Actual FY07
Individual Income Tax	3,689.5	3,857.0	4.5%	3,735.7	1.3%	3,972.0	6.3%	3,746.1	0.3%
Corporate Income Tax	874.2	1,014.2	16.0%	986.2	12.8%	995.4	0.9%	935.5	-5.1%
Transaction Privilege and Use Tax	4,273.4	4,559.8	6.7%	4,457.5	4.3%	4,899.9	9.9%	4,633.2	3.9%
Other Taxes	480.0	487.8	1.6%	492.7	2.6%	460.6	-6.5%	507.3	3.0%
Total Taxes	\$9,317.1	\$9,918.8	6.5%	\$9,672.1	3.8%	\$10,327.9	6.8%	\$9,822.1	1.6%
Urban Revenue Sharing	(\$425.2)	(\$551.2)	29.6%	(\$551.2)	29.6%	(\$684.5)	24.2%	(\$684.5)	24.2%
TOTAL TAXES NET URS	\$8,891.8	\$9,367.5	5.3%	\$9,120.9	2.6%	\$9,643.4	5.7%	\$9,137.5	0.2%
Non-Tax Revenues	\$274.9	\$310.4	12.9%	\$323.7	17.8%	\$314.1	-3.0%	\$312.2	-3.5%
TAX AND NON-TAX REVENUES	\$9,166.7	\$9,678.0	5.6%	\$9,444.5	3.0%	\$9,957.5	5.4%	\$9,449.7	0.1%
Disproportionate Share Adjustments	\$108.0	\$113.1		\$113.1		\$73.6		\$73.9	
	\$10.0								
<b>TOTAL ALL REVENUES</b>	<b>\$9,284.7</b>	<b>\$9,791.1</b>	<b>5.5%</b>	<b>\$9,557.7</b>	<b>2.9%</b>	<b>\$10,031.1</b>	<b>5.0%</b>	<b>\$9,523.6</b>	<b>-0.4%</b>

## REVENUE COLLECTIONS



**FY08 SOURCES AND USES  
BUDGET MANAGEMENT PLAN  
(\$000)**

	FY 2007 Actuals	FY 2008 Enacted Budget	FY 2008 December Estimate
<b>SOURCES OF FUNDS</b>			
Balance Forward	1,046,460.1	529,029.6	377,947.0
Adjustment to Balance Forward	(23,555.0)	0.0	0.0
Base Revenues	10,108,900.7	10,715,570.9	10,208,103.3
Urban Revenue Sharing	(551,230.7)	(684,538.9)	(684,538.9)
Adjusted Base Revenues	9,557,670.1	10,031,032.0	9,523,564.4
SFB Building Renewal Transfer 1/	60,080.5	0.0	0.0
Ladewig Refunds	(80,735.9)	0.0	0.0
Unclaimed Property	0.0	45,000.0	45,000.0
Excess Balance Transfer from BSF	18,576.0	0.0	0.0
<b>TOTAL SOURCES OF FUNDS</b>	<b>10,578,495.8</b>	<b>10,605,061.6</b>	<b>9,946,511.5</b>
Total Operating Budgets	9,771,306.3	10,643,946.4	10,643,946.4
Reserve for Budget Supplemental Requirements 2/	0.0	0.0	120,714.6
Payback K-12 Rollover 3/	191,000.0	0.0	0.0
Total Operating Budgets	9,962,306.3	10,643,946.4	10,764,661.0
Building Renewal and Capital Outlay	80,354.2	19,934.5	19,934.5
Highway Construction	245,000.0	0.0	0.0
Administrative Adjustments 4/	75,105.5	65,163.0	97,700.0
Revertments 5/	(162,217.2)	(125,283.1)	(75,352.6)
Reserve for Ending Balance	0.0	0.0	10,000.0
<b>USES OF FUNDS</b>	<b>10,200,548.8</b>	<b>10,603,760.8</b>	<b>10,816,942.9</b>
ENDING BALANCE	377,947.0	1,300.8	(870,431.4)
<i>Budget Management Plan</i>			
Budget Savings			214,055.1
Rainy Day Fund (BSF) Transfer			263,376.3
K-12 Capital Finance			393,000.0
<b>ENDING BALANCE AFTER BUDGET MANAGEMENT</b>			<b>10,000.0</b>

1/ In FY 2006, Laws 2005 Chapter 287 Section 9 required the transfer of \$60 million from the Building Renewal Fund to the General Fund. This transfer was not implemented until FY 2007.

2/ The FY 2007 Total Operating Budget of \$9.7 billion includes 2007 Supplementals.

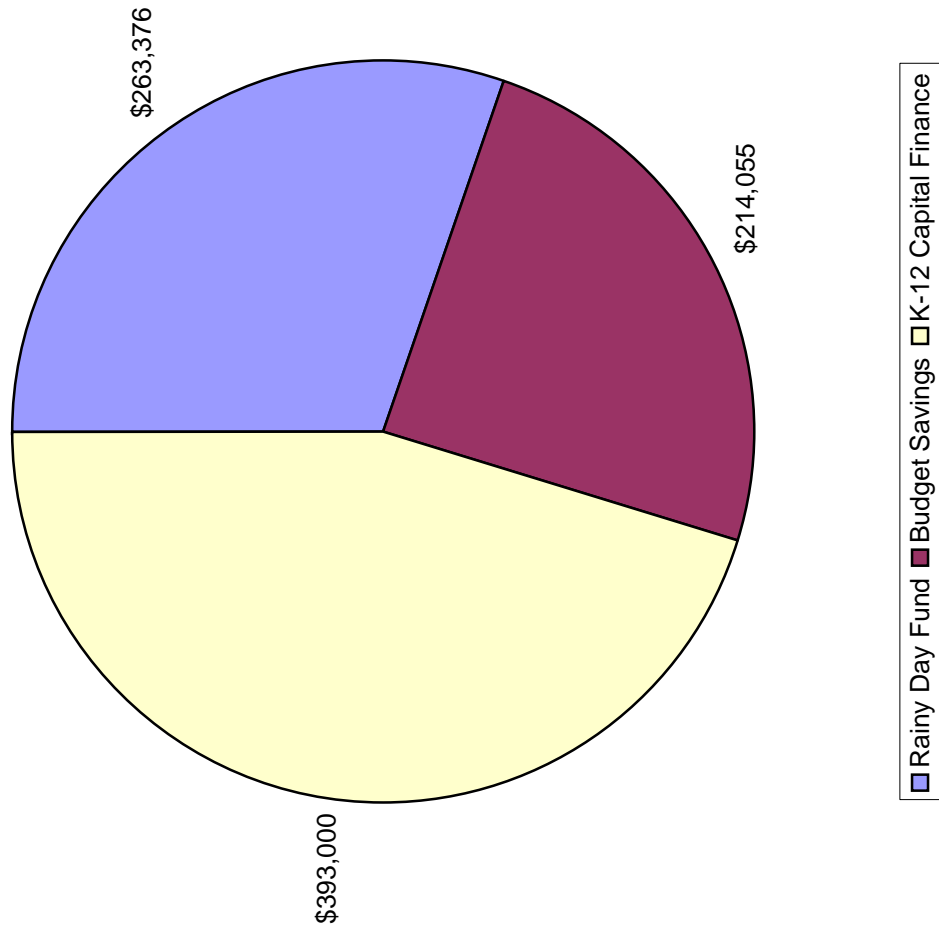
3/ \$191M K-12 Rollover was recorded as a FY06 appropriation, but did not occur in FY06 as intended by the legislation since the effective date of the appropriation was beyond the end of FY06. Therefore this amount is shown in FY07.

4/ Administrative Adjustments reflect payments which occur after the fiscal year ends for goods and services purchased during the fiscal year. Typically these are the result of invoicing delays or the timing of payment processing. Because the accounting books have been closed for the fiscal year, the expenditures are counted in the subsequent year.

5/ Revertments reflect remaining unexpended agency appropriations at the end of the fiscal year. This is commonly the result of unrealized caseload or formula funding growth, vacancy savings, operating efficiency initiatives or other savings resulting from normal operations management. These are not the result of directed budget reductions which typically include decreased appropriations.



**FY08 Budget Management Plan  
(000s)**



## OVERVIEW OF THE BUDGET MANAGEMENT PLAN

At the Governor's direction, the Governor's Office of Strategic Planning and Budgeting prepared a Budget Management Plan to meet the challenges of the fiscal situation now faced by the State of Arizona. This Plan has been developed to solve the Fiscal Year 2008 shortfall which is currently estimated to be approximately \$870 million.

The policies we used to achieve this plan are as follows:

1. The integral functions of State government must not be compromised and our commitment to efficiency and excellence must be maintained.
2. Recommended spending reductions will be on an agency-by-agency and program-by-program basis, not across-the-board.
3. The Arizona education system – including all public K-12 and higher education programs – are exempt from spending reductions.
4. Other programs and services affecting Arizona's children and vulnerable adults will be exempt from spending reductions.
5. Appropriate application of previously used and accepted budgetary practices will be employed.

The Budget Management Plan consists of three primary elements. First, is a **State agency budget savings strategy** which will reduce State general fund expenditures by \$214 million in FY 2008. Second, the use of **capital financing** in place of paying cash for school construction allows for lease purchase of \$393 million of elementary and secondary school facilities during FY 2008. Third, it is once again time to tap the **State savings account** by utilizing \$263 million of the nearly \$700 million<sup>1</sup> in the Rainy Day Fund (BSF) as a short-term fiscal bridge. Additional detail regarding each of the elements of the Plan is provided in the following pages.

The following chart summarizes the key elements of the Plan:

State Agency Budget Savings	\$214,000,000
K-12 Capital Financing	393,000,000
Rainy Day Fund	<u>263,000,000</u>
Total Budget Management Plan	\$870,000,000

The current plan follows the guidelines set forth by the Governor in September 2007.

	September 2007 Plan	% of total	January 2008 Plan	% of total
<b>Shortfall</b>	\$600		\$870	
<b>Budget Savings</b>	100	17%	214	25%
<b>K-12 Capital</b>	300	50%	393	45%
<b>Rainy Day Fund</b>	200	33%	263	30%

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<sup>1</sup> The cash balance of the Rainy Day Fund as of November 2007 was in excess of \$685 million and will continue to add several million dollars each month through the end of the fiscal year.

## **K-12 Capital Finance**

### **Financing New Schools – Improving the K-12 Capital System**

The State of Arizona currently spends over \$400 million per year on new school construction and anticipates spending over \$500 million per year within the next three years. For FY 2008, the Legislature provided \$370 million in General Fund monies to the School Facilities Board to provide for this need. However, with lower than expected revenues and higher than expected new school construction costs, the State must look to other means to provide for K-12 capital needs.

The Governor has proposed financing the cost of building new schools. There are several reasons why financing new school costs is the right step for Arizona.

1. In almost every state, state and local governments use long-term financing for new schools.
2. Long-term financing is used by families, businesses, and local governments to acquire long-term capital assets.
3. The state uses capital financing for the construction of government buildings, universities and for roads.
4. Future Arizonans will benefit from schools built today for the next 50 years so it is fair for future Arizona beneficiaries share in the cost of building and financing their schools.
5. Current financing market conditions are favorable. Long-term financing will cost the state less than 5 percent.
6. The new school construction program needs to be expanded to accommodate full-day kindergarten. Financing provides the ability to complete this expansion today.
7. Financing new schools creates opportunities to implement 21<sup>st</sup> century improvements in school infrastructure including improvements in energy, safety, and technology.
8. Financing in FY 2008 will free approximately \$400 million in General Fund dollars to help balance the Budget.
9. Financing in FY 2009 will free more than \$400 million in General Fund dollars for other priorities.
10. Over the next five years, long-term financing would reduce the General Fund cost of new school construction by \$2.2 billion allowing the State to invest in other critical areas such as, healthcare, K-12 education, universities and public safety.
11. New schools are capital assets with a use period exceeding 50 years. Roads, as a comparison, only have a 30 to 40 year expected life.

# **RAINY DAY FUND (BUDGET STABILIZATION FUND) TRANSFER**

## **Summary**

The Budget Stabilization Fund (BSF) for Arizona was enacted in 1990 (A.R.S. § 35-144). The BSF is designed to set revenue aside during times of above-trend economic growth and to utilize this revenue during times of below-trend growth. It is, in essence, the state's savings account. In prior years, the BSF has been tapped for uses not originally intended by the statute. For example, funds from the BSF were used to pay for the Arizona State Hospital in Fiscal Years 2000-2003 and in Fiscal years 2001-2007 BSF funds were transferred for payments on the Alternative Fuels Tax Credit. The use of the BSF in the Governor's Budget Management Plan is exactly consistent with the intended use of the fund.

The current cash balance in the BSF is in excess of \$685 million<sup>1</sup> after a transfer of \$18.6 million in excess balance to the General Fund. The Governor's proposal is to transfer \$263 million to the General Fund to help balance the FY 2008 budget, utilizing the BSF for its intended purpose. This leaves \$422 million plus any unrealized investment gains in the BSF.

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## **STATE AGENCY BUDGET SAVINGS**

### **State Agency Spending Reductions**

• Department of Corrections	\$19.4 million
• Economic Security	\$ 6.5 million
• Commission for Postsecondary Education	\$ 5.3 million
• Department of Health Services	\$ 5.2 million
• AHCCCS	\$ 3.9 million
• Department of Revenue	\$ 2.4 million
• Other	<u>\$32.8 million</u>

Total	\$75.5 million
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### **Spending Reductions from Fund Balances<sup>2</sup>**

• Citizen's Clean Election Fund	\$ 24.0 million
• State Aviation Fund	\$ 15.0 million
• Underground Storage Tank Revolving Fund	\$ 12.8 million
• Housing Trust Fund	\$ 6.5 million
• Clean Air In-Lieu Fee Account	\$ 6.1 million
• Supreme Court CJEF Disbursement Fund	\$ 6.0 million
• Other	<u>\$ 57.9 million</u>

Total	\$128.2 million
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**Ex-Appropriations of Capital Outlay and Continuing Appropriations** \$ 10.3 million

<b>TOTAL STATE AGENCY BUDGET SAVINGS</b>	<b>\$214.1 million</b>
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<sup>1</sup> Through November 2007.

<sup>2</sup> Fund balances are part of Agency total resources available for operating or capital needs. Reductions to these balances represent real cuts to the resources agencies have at their disposal.

**IMPACT OF SELECTED STATE AGENCY BUDGET SAVINGS  
FY 2008**

1. Reduce the expected number of Arizona inmates housed in Indiana by 630. (\$14.8 million)
2. Include funding of schematic design for Universities Biomedical campus in capital financing plan for FY09. (\$10.5 million)
3. Reduce funds available for Private Postsecondary Education grants. (\$5 million)
4. Defer the development of the call center portion of the 2-1-1 system. (\$1.9 million)
5. Revise the loading schedule for inmate beds in Oklahoma. (Effectively stretch out the loading of the first 916 inmates by five weeks and the remaining 424 inmates by thirteen weeks.) (\$1.6 million)
6. Reduce by one in number of rural organizations or community E-Health collaborations that can be funded from GITA. (\$100,000)
7. Eliminate new technology grant program. (\$1 million)
8. Delay in planned expansion of the arrestee DNA testing program. (\$600,000)
9. Defer the replacement of the AHCCCS claims computer system. (\$500,000)
10. Delay in preparation of twelve parcels of land for auction by the State Land Department. (\$300,000)
11. Delay in hiring of four new detention transport Officers. (\$250,000)
12. Reduce the number of Highway Patrol vehicles replaced this year from 171 to 165.
13. Slow the processing time for claims made to the Department of Insurance Consumer Services Division.
14. Reduce or eliminate tuition reimbursements.
15. Delay/reduce funding for technology enhancements.
16. Reduce/eliminate both in-state and out of state travel.
17. Generate vacancy savings through hiring deferrals.